Internal Revenue Service

memorandum

CC:TL:Br3
PScott-Clayton

date: NOV 15 1988

to: Utility Industry Specialization Program - Team Leader
Cleveland District

from: Assistant Chief Counsel (Tax Litigation) CC:TL:Br3

---

subject: [redacted] Divestiture - Research Credit Base Period Costs

Introduction

This is in response to your September 20, 1988 request for our views on whether the [redacted] divestiture qualifies as an acquisition/disposition for purposes of the Credit for Increasing Research Activities.

Issue

Whether the [redacted] divestiture is an acquisition/disposition for purposes of the Credit for Increasing Research Activities.

Conclusion

The [redacted] divestiture is an acquisition/disposition for purposes of the Credit for Increasing Research Activities.

Background

On [redacted], the United States District Court for the [redacted] ordered [redacted] to divest itself of [redacted]. Under the terms of the divestiture order, [redacted] was required to transfer to the [redacted] sufficient facilities, personnel, systems, and rights to technical information to permit then to perform independently of [redacted].

Pursuant to that order, effective [redacted], [redacted] transferred various assets to the [redacted] which were then placed in newly created subsidiaries. The [redacted] then spun off ownership in the subsidiaries to [redacted] by declaring a stock dividend. [redacted] were formed from the subsidiaries that were spun off. The stock in the [redacted] was distributed to [redacted]'s shareholders on [redacted].

The Service issued a private letter ruling on [redacted] to [redacted] that the asset and stock transfers among [redacted] and its affiliates were tax free under I.R.C. §§ 351, 354, 355 and 361, or under Treas. Reg. § 1.1502-14(a).

[redacted] and the [redacted] have concluded that the divestiture is an acquisition/disposition for purposes of the Credit for Increasing Research Activities. There are indications that this will result in a substantial tax advantage to [redacted].

Analysis

Section 30(a) of the Internal Revenue Code of 1954 1/ (hereafter, I.R.C. § 30(a)) allows a credit for increased research activities. To compute the credit under I.R.C. § 30(a), a taxpayer must first determine the "qualified research expense" for the taxable year. The amount of the credit will be 25% of the excess (if any) of "qualified research expense" over "base period research expenses." "Base period expenses" are the average "qualified research expenses" paid or incurred for each year in the applicable base period in I.R.C. § 30(c). The base period is one year with respect to determination years ending after June 30, 1981 and increases to the general three-year period starting with years ending after June 30, 1983. The base period research expenses may never be less than 50% of the qualified research expenses for the determination year. This 50% limitation applies to newly organized and existing businesses.

After June 30, 1980, a taxpayer that acquires a major portion of a trade or business of another person (a predecessor), or the major portion of a separate unit of a trade or business of a predecessor, must increase the amount of its qualified research expenses for periods before the acquisition, by the amount of the qualified research expenses of its predecessor attributable to the trade or business or separate unit of a trade or business acquired by the taxpayer. I.R.C. § 30(f)(3)(A).2/

1/ Section 30 was in effect during taxable year 1984, the year of divesture. Section 30 was originally enacted as Section 44F. Under Section 471(c) of the Tax Reform Act of 1984, Section 44F was redesignated Section 30. Section 231 of the Tax Reform Act of 1986 redesignated Section 30 as Section 41, effective for taxable years after December 31, 1985.

2/ Thus, the acquiring taxpayer's current "qualified research expenses" as well as "base period expenses" may be increased under I.R.C. § 30(f)(3)(A).

Conversely, after June 30, 1980, a taxpayer that disposes of a major portion of a trade or business or separate unit of a trade of business, must reduce its qualified research expenses attributable to the disposed trade or business or separate unit of a trade or business, but only if the disposing taxpayer furnishes the acquiring taxpayer "such information as is necessary for the application of [I.R.C. § 30(f)(3)(A)]."

The acquisition/disposition rules are to be applied under regulations prescribed by the Secretary. I.R.C. § 30(f)(3)(B). Proposed regulations § 1.44F-7(b) states:

> For the meaning of "acquisition", "separate unit", and "major portion", see paragraph (b) of 26 CFR 1.52-2 (Revised as of April 1, 1982.) An "acquisition" includes an incorporation or a liquidation.

The inclusion of two potentially nontaxable corporate events, "incorporation" and "liquidation," in the above definition of "acquisition" is significant. This means acquisition/dispositions are not limited to sale or exchange transactions or other taxable events. We found nothing in the statute, regulations or legislative history which would require such a distinction.

Further, as noted above, proposed regulation § 1.44F-7(b) also refers to 26 CFR 1.52-2 for a definition of "acquisition," "separate unit" and "major portion".3/ Treas. Reg. § 1.52-2(b)(1) states:

3/ Section 52(c) as original enacted by Section 202(b) of the Tax Reduction Act of 1977, contained acquisition/disposition provisions that were virtually identical to those subsequently enacted by Section 44F(f)(3) in by the Economic Recovery Act of 1981. Section 52 contained special provisions for application of section 44B, the New Jobs Credit. Section 44B was amendment by the Revenue Act of 1978 and became Section 51, the Targeted Jobs Credit. A conforming amendment was made to Section 52 by the Revenue Act of 1978 to make it applicable to I.R.C. § 51 rather than I.R.C. § 44B. Section 52(c) was repealed by Section 321(c)(1)(A)(i) of the Revenue Act of 1978, effective December 31, 1978. However prior its repeal, on July 2, 1978, regulations were issued under Section 52(c) defining "acquisitions," "seperate unit" and "major portion" for purposes of that section. See Treas. Reg. § 1.52-2; T.D. 7553, 1978-2 C.B. 11. Treas. Reg. § 1.52-2 was amended on November 15, 1983 to clarify that the acquisition/disposition rules applied only to the New Jobs Credit. T.D. 7921, 1983-2 C.B. 3.

(i) For purposes of this section, the term "acquisition" includes a lease agreement if the effect of the lease is to transfer a the major portion of the trade or business or of a separate unit of the trade or business for the period of the lease. For instance, if one company leases a factory (including equipment) to another company for a two-year period, the employees are retained by the second company, and the factory is used for the same purpose as before, then for purposes of this section the lessee has acquired the lessor's trade or business for the period of the lease.

(ii) Neither the major portion of a trade or business nor the major portion of a separate unit of a trade or business is acquired merely by acquiring physical assets. The acquisition must transfer a viable trade or business.

Treas. Reg. § 1.52-2(b)(2) states that a "seperate unit" of a trade or business is "a segment of a trade or business capable of operating as a self sustaining enterprise with minor adjustments."

All facts and circumstances surrounding the transaction shall be taken into account in determining what consitutes a major portion of a trade or business or seperate unit, including: (1) the relative fair market value of assets; (2) the goodwill allocations; (3) the number of employees before and after the transfer; and (4) the gross sales, net income and budget of the transferred portion. Treas. Reg. § 1.52-2(b)(3).

In Willinger v. Commissioner, T.C. Memo. 1983-159, 45 TCM (CCH) 1069 (1983), a business was operated as a sole proprietorship until July 1, 1977 when the petitioner transferred the business to his wholly owned corporation in a tax-free exchange under I.R.C. § 351. The court held that the transfer was a "disposition" within the meaning of Section 52(c). See also LTR 8519007 (January 25, 1985).

In determining whether there has been an acquisition/ disposition for purposes of the Credit for Increasing Research Activities, the emphasis is therefore on whether a viable trade or business was transferred. The terms or taxable nature of the transfer is irrelevant so long as a viable business has changed hands. The legislative history for the Credit for Increasing Research Activities reinforces this point. It states that the credit contains special rules for computing the credit "where a business changes hands." H. Rept. No. 97-201, pp. 124-25.

In the instant case, [redacted] transferred a viable business to the [redacted] the [redacted]

These assets constitute a separate unit of the trade or business of [redacted]. Therefore, the transfer of the [redacted] to the [redacted] by [redacted] is an acquisition/disposition of a separate unit of a trade or business for purposes of the Credit for Increasing Research Activities 4/.

[redacted]'s subsequent distribution of the stock in the [redacted] to its shareholders removed the [redacted] from [redacted]'s controlled group. Therefore the aggregation rule of I.R.C. § 30(f)(1) no longer applies. Accordingly, [redacted] is entitled to reduce its "qualified research expenditures" and "base period expenses" by the amount attributable to the trade or business transferred to the Regional Operation Companies to the extent that [redacted] supplies sufficient information to the acquiring taxpayers for application of I.R.C. § 30(f)(3)(A).

MARLENE GROSS

By: _____
DANIEL J. WILES
Chief, Branch No. 3
Tax Litigation Division

4/ It is also possible that the [redacted] constitutes a major portion of [redacted]'s trade or business. Additional information would be needed to make this determination. See Treas. Reg. § 1.52-2(b)(3).